

Stock picking becomes an essential art



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Stock markets in Canada and around the world had a terrific run from 1982 to 1999, with only a few small setbacks. Equity investments, even on autopilot, made money. Passive portfolio management ruled. There was no need to pick stocks as it was cheaper and easier to diversify and make money by buying an index fund.

Studies in both the U.S. and Canada clearly showed that only a small number of actively managed funds beat indexes. This led to a proliferation of index funds and eventually exchange-traded funds – a trend that has continued with ETFs growing, in terms of assets, at an annual rate of 29.6 per cent during the past five years versus 5.6 per cent for mutual funds in general, according to the business journal Investment Executive. This is modern portfolio theory in action – diversification and cost minimization – and this is what index funds do best.

But the future is going to be different. Passive and autopilot investments will not be as

profitable as in the past.

Stock markets are going to be increasingly volatile as productivity growth slows, taxes increase and government spending declines, coupled with population growth slowing and turning negative in many Western countries, baby boomers retiring and spending their hard-earned money rather than saving and investing, and eventually inflation and interest rates rising.

Further contributing to that volatility is the proliferation of highly speculative instruments, such as the recently announced eight new ETFs sponsored by ProShares that “promise to return three times the positive or negative return of four major equity indexes” and are designed to be held for a maximum of one day. Wall Street, with stock markets around the world following its lead, is starting to become a casino.

Moreover, hedge fund behaviour, and that of speculators in the commodity markets that led to the extreme volatility of commodity and energy prices in the last few years, will continue to add to the casino-like behaviour of stock markets. This trend is going to intensify.

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According to market efficiency and modern portfolio theory, attempting to outperform the market based on stock picking will lead to a

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poorly diversified portfolio and risk for which there will be no reward. Diversification, according to the theory, helps investors minimize risk and therefore avoid losses.

But value investors don't believe in market efficiency and put less emphasis on portfolio diversification. They don't believe risk is measured by the volatility of stock returns – a key measure of risk that is reduced through diversification. Rather, volatility is a value investor's best friend as it gives rise to trading opportunities.

Modern portfolio theory regards diversification as a substitute for due diligence. Value investors disagree. In fact, value guru Warren Buffett, who I recently visited in Omaha, has indicated that wide diversification is only required when investors do not understand what they are doing. The importance of due diligence for value investors can't be overstated and will be critical in this era of stock picking.

Similarly, modern portfolio theory and diversification reject a case-by-case stock analysis. Value investors disagree. Evaluating each stock on its own merit is what value investors do. Diversification and in-

discriminately buying a large number of stocks (i.e., index funds) will not save a portfolio in the future. The last few years have been a prelude of this.

Valuing individual securities and having concentrated portfolios will be worthwhile. Value investors have concentrated portfolios, not because they reject diversification, but rather because they operate within the boundaries of their competence by choosing securities they understand. They prefer companies that can be reliably valued with stable cash flows and a history of steady earnings. They look at investment opportunities intuitively; they're skeptical if something doesn't make sense. They buy businesses cheap based on their assets or future earnings. By not paying for growth, they protect their capital and limit risk. Additionally, they apply a margin of safety, which provides downside protection.

Value investors hold cash when they can't find stocks that are underpriced. A lack of new opportunities is a sign for them that the market may be overvalued. This is not a market timing call made on a macroeconomic forecast. It is the result of a bottom-up search for good investments that at the moment comes up empty.

The ability to correctly pick the right stocks is about to get a lot more important. Selecting the right stocks will do more to mitigate risk than controlling and managing risk through diversification.

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